

California Court of Appeal Rules That a Trust is Taxable on All California Source Income, Without Regard to the Residence of Fiduciaries

Overview

On June 29, 2020, a California Court of Appeal (Court) held that a trust's California source income is taxable in full on a source basis, rejecting the trust's novel claim that its California source income was apportionable in the same manner as the trust's non-California source income.¹ Additionally, the Court held that the California resident beneficiary's interest in the trust was contingent because the terms of the trust instrument gave the trustees complete discretion to determine if and when to make distributions to the beneficiary.²

This Tax Alert summarizes the Court's decision and provides some considerations for taxpayers.

Background

The Paula Trust (Trust) had two individual trustees, one a California resident, and the other, a Maryland resident.³ The sole beneficiary of the Trust was a California resident. The Trust owned an interest in a limited partnership, which in turn, owned stock of a corporation. In 2007, the partnership sold the stock and realized capital gain. The Trust's share of the gain was \$2,831,336. The Trust's 2007 California fiduciary income tax return reported the entire amount of the gain as California source income and the Trust paid the associated tax.

In 2012, the trustees of the Trust filed an amended return for 2007, requesting a refund of 50% of the tax on the ground that, under Section 17743 of the Revenue and Taxation Code, discussed below, only half of the gain was taxable in California because only one of the Trust's two fiduciaries was a California resident. After the claim was deemed denied by operation of law, the trustees filed an administrative appeal with the California State Board of Equalization. The Board rejected the claim and the trustees filed suit in state court.

At the trial court, the California Franchise Tax Board (FTB) argued that trusts are taxed in the same manner as individuals and, because California source income is always taxable to individuals—residents are taxed on their entire taxable income regardless of source, and nonresidents are taxed on their California source income—then, likewise, California source income is always taxable to trusts. The Trust countered that the statutes imposing tax on residents and nonresidents apply to individuals only (*i.e.*, natural persons), and, in any event, the plain language of Section 17743 operated to apportion the Trust's entire income, including California source income, based on the residence of the Trust's fiduciaries.

The FTB further asserted that the California resident beneficiary's interest in the trust was not contingent and that, as a result, all of the Trust's income was taxable regardless of whether or not it was California source income. The trial

¹ *Steuer, et al. v. Franchise Tax Bd.*, No. A154691, 2020 Cal. App. LEXIS 592 at *19 (June 29, 2020), *aff'g* in part and *rev'g* in part *Paula Trust, et al. v. Cal. Franchise Tax Bd.*, No. CGC-16-556126, 2018 Cal. Super. LEXIS 644 (Cal. Super. Ct. Feb. 6, 2018).

² *Id.* at *23.

³ *Id.* at *2.

court ruled in favor of the Trust on summary judgment, granting the refund and ruling that the beneficiary's interest in the Trust was contingent.⁴ The FTB appealed and this decision followed.

The Court's Decision on the Taxability of a Trust's California-Source Income

Reviewing the trial court's ruling *de novo*, the Court held that a trust's California source income is always taxable because: (1) a trust computes its taxable income in the same manner as an individual; (2) the taxable income of an individual (whether a resident or nonresident) always includes California source income; and (3) since California source income in the hands of a resident or a nonresident is taxable in all events, the same is true for a trust. In support of its analysis, the Court cited to Section 17731, which incorporates federal tax statutes applicable to trusts, and requires a trust to compute its taxable income in the same manner as an individual for federal tax purposes; Section 17041(e), which requires a trust to pay "taxes equal to the amount computed under subdivision (a) [of Section 17041] for an individual having the same amount of taxable income;" and case law generally noting that California taxes the income of a trust as if it were an individual.

Next, the Court considered Section 17743, which states: "Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the [FTB]." Section 17742 states, in relevant part, that "tax applies . . . to the entire taxable income of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident[.]" The FTB's longstanding regulations direct trusts to pay tax on California source income in all events and to apportion the non-California source income.⁵ The Trust argued that Section 17743, by virtue of its reference to the income taxable under Section 17742, operated to apportion the Trust's entire taxable income (*i.e.*, both its California and non-California source income), and that to the extent the regulation provided otherwise, it was invalid.⁶

The Court disagreed and said, "the plain language of Section 17743 and its rules require taxing all of a trust's California-source income and apportioning only income derived outside of California according to the number of resident fiduciaries." The Court's plain meaning analysis focused on the following phrase contained within Section 17743: "depends on the residence of the fiduciary." The Court reasoned that California's ability to tax California source income never "depends on the residence the fiduciary" because California source income is always taxable on a source basis. Conversely, the taxability of non-California source income "depends on the residence of the fiduciary" because "the only basis for taxing the income is residency."

Returning to the plain language of Section 17743 (above), the Court concluded that the statute applies in the "limited circumstance" where a trust has non-California source income and two or more fiduciaries. "In that situation, the non-California-source income that is taxable under Section 17742 'shall be apportioned according to the number of fiduciaries resident in this state[.]'" Stated differently, whereas a trust's "entire taxable income" (the phrase used in Section 17742) necessarily includes California and non-California source income, only a subset of that amount—the non-California source income—"depends on the residence of the fiduciary" and is apportioned under Section 17743.⁷

⁴ *Paula Trust, et al. v. Cal. Franchise Tax Bd.*, No. CGC-16-556126, 2018 Cal. Super. LEXIS 644 (Cal. Super. Ct. Feb. 6, 2018).

⁵ 18 Cal. Code Regs. § 17742-17744. See also California FTB Legal Ruling No. 238 (Oct. 27, 1959). If the income in question—the Trust's share of the gain realized by the limited partnership on the sale of stock—were not California source income, then only 50% of the income would be taxable under these rules even under the FTB's position. Our understanding based on the parties' appellate briefs is that the parties stipulated that the income was California source income.

⁶ It appears that the Trust was the first to argue that California's tax statutes fail to tax the entirety of a trust's California source income at all times.

⁷ Arguably, the Court's construction does not fully address the second clause of Section 17743, which states: "the income taxable under Section 17742 [*i.e.*, the entire taxable income] shall be apportioned[.]" The Court interprets "the income taxable under Section 17742" as "the non-California source income that is taxable under Section 17742." But even though the taxability of California source income may not depend on the residence of the fiduciaries, the second clause of § 17743 could operate to apportion the Trust's entire taxable income as the Trust claimed.

The Court's Decision on Whether the Beneficiary's Interest in the Trust was Contingent

The Court affirmed the trial court's holding that the California resident beneficiary's interest in the trust was contingent. The Court recognized that, under California law, a beneficiary holds a contingent interest in a trust if the trustee has absolute discretion to determine if and when to make distributions of trust income and principal to the beneficiary.⁸ The Court found that this determination requires a review of the trust instrument to determine "whether there are any limitations on a trustee's discretion to distribute income to a beneficiary." In reviewing the trust instrument, the Court found that the two trustees were authorized, but not required, to distribute as much trust income and principal as the trustees deemed to be in the beneficiary's best interest.

The FTB argued that, aside from reviewing the trust instrument, there must be a factual inquiry to determine the specific nature of a beneficiary's interest. In this case, the FTB argued that the beneficiary's interest in the trust income was noncontingent because the trustees notified the beneficiary of future distributions; the beneficiary relied on those distributions in making financial decisions; and the beneficiary directed how the trustees would pay the distributions. The Court declined the FTB on this point, noting that despite these facts, the trustees had complete discretion to decide if and when to make distributions.

Considerations

The Court's decision is not yet final. Trustees that have filed protective refund claims pending the outcome of this decision are advised to continue to monitor the case before taking further action. A Court of Appeal decision generally becomes final 30 days after the decision is filed or certified for publication, unless a petition for rehearing is timely filed and granted within this 30-day period.⁹ If no petition is filed, or if the petition is not granted, then the parties have 10 days to file a petition with the California Supreme Court for a review of the Court's decision.¹⁰ Additionally, the California Supreme Court may, upon its own motion or in response to a request by any person within 30 days after the Court's decision becomes final, depublish the Court's decision.¹¹ A decision to depublish a Court of Appeal opinion does not mean that the Supreme Court overruled or disagreed with the ruling. Rather, it means that the depublished opinion cannot be cited as authority or precedent in other matters. We will continue to provide updates on this case.

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⁸ 18 Cal. Code Regs § 17742(b); Cal. Franchise Tax Bd., Technical Advice Mem. 2006-0002 (Feb. 17, 2006).

⁹ CA Rules of Court, Rules 8.264, 8.268.

¹⁰ CA Rules of Court, Rule 8.500.

¹¹ CA Rules of Court, Rule 8.1125.

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